Prop. 200—Payday Reform by the Payday Industry: it's about profits, not people

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July 1, 2010 has the Payday loan industry petrified. Unless the legislature acts, the 2000 law which allowed Payday lending in Arizona will expire and they'll be out of business[2]. They haven't stood pat. Under the guise of their trade association, the Arizona Financial Services Community Association, Payday lenders have anted up a whopping $11.6 million dollars to place Prop. 200 on the ballot and try to pass it.[3]

On paper Prop. 200 appears to provide some commonsense reforms that would improve the industry. The reforms include a limit of one loan at a time, a requirement to repay that loan before obtaining a new one (no rollovers), a statewide database to monitor this, and a 60 day interest-free option if a borrower runs into difficulty repaying. These would appear to remedy the biggest concern people have about payday lenders, that they take advantage of people in vulnerable circumstances, where people ending up paying hundreds of dollars in fees in just a few months for a couple hundred dollar loan.

But Florida has all of these reforms and we still see a familiar pattern of an industry whose business model is predicated on chronic borrowers, meaning Payday lenders want a person to re-borrow the same $300 repeatedly over a short period of time to enhance profits. Even if we use data from White Papers by Veritec Solutions, LLC, a company hired by states to monitor Payday loan usage, that criticizes the Center for Responsible Lending, one of the harshest critics of Payday lenders, we still find the Payday loan industry, even after reform, relies on chronic borrowers.

Most notably, the Payday Loan Reform Act allows fees of up to 15 percent of the amount borrowed and caps the length of a loan at just 35 days, giving borrowers who truly are in a difficult financial situation insufficient flexibility at high cost—as borrowers typically take out a new loan immediately rather than

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[2] "Guest Opinion: Borrowers trapped in debt cycle," Donald W. Carson, Tucson Citizen, August 25, 2008, http://www.tucsoncitizen.com/ss/related/94570.

[3] "Payday Loan Group Beefs Up Campaign" by Howard Fischer, Capitol Media Services, Arizona Daily Star, September 16, 2008, Http://Www.Azstarnet.Com/Metro/257745.Php

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use the extended payback option. And short terms of as little as 5 days for loans are also permitted by the ballot initiative.

While the proposition does allow a two month interest-free repayment period[4], its use is limited to once per year per lender and evidence from other states suggest that most customers are more likely to repay and take out a new loan immediately than enter into the repayment plan.

Prop. 200 would eliminate some of their worst customers, those unable to pay back their loans because they are taking out loans at numerous outlets, but Prop. 200 fails to substantially change the product that is offered. A product with a slightly higher maximum fee of $20 per $100 and a much longer minimum 90 day repayment period would far better match the credit needs of customers than what is offered in Prop. 200, especially if combined with financial planning assistance. The Payday loan industry won't offer that reform because it would cut too much into their profits.

Below I profile the customers, lending patterns and business model for the industry based on the best publicly available data from academic scholars and Payday data base firms.

1. Payday Lenders serve a minute portion of the adult population—who tend to be younger with poor credit and/or problems managing finances

A 2005 consumer survey cited by a George Washington University business school research team found that only two percent of households had used Payday lenders in the past year.[5] Hence, Payday loans are not a wide market, nor are necessarily Payday customers particularly poor, though some are. A better picture are that these are people who often have financial management problems, and Payday loans often fail to address these underlying issues, even with the proposed Prop. 200 reforms.

[4] The exact language is four pay periods, which I'm assuming are bimonthly. If the person is unemployed, the repayment plan extends to four months, once per month (Payday Loan Reform Act Initiative Language, p. 5).

[5] "A Comparative Analysis of Payday Loan Customers," By Edward C. Lawrence and Gregory Elliehausen, Financial Services Research Program, Working Paper No. 71, June 2007, p. 8.

A 2001 Georgetown University Business School study[6] examining a 2000 survey paints a profile of Payday loan customers as one-fourth having incomes exceeding $50,000 and three-fourths having incomes exceeding $25,000. In today's dollars those figures would be approximately 20-25 percent higher. They are poorer than adults overall, but not markedly so.[7] The Payday loan industry generally concurs with these estimates while some studies from Illinois, Wisconsin, Colorado and Illinois suggest the typical customer's income is $25,000 to $28,000.[8]

However, they do tend to be much younger than the general population. Nearly 70 percent of Payday loan customers are under 45 compared to half of the adult population falling in the same age group. The most marked distinction between Payday loan customers and the overall population is that 40 percent of Payday loan customers were unmarried with incomes between $25 and $50 thousand with children, while only 16 percent of the overall adult population falls in that category.[9]

When queried about Payday loans, customers generally offer self-serving answers favoring loans but looking for a limit on the fees charged, [10] something, incidentally that Prop. 200 fails to do since it institutionalizes current fees.[11]

Just over half of Payday loan customers have a credit card compared to nearly three-quarters of the adult population. Among Payday loan customers who had credit cards, 60 percent reported maxing out their credit card.

[6] "Payday Advance Credit In America: An Analysis of Customer Demand" by Gregory Elliehausen and Edward C. Lawrence, Credit Research Center, McDonough School of Business. Georgetown University, April 2001.
[7] "Payday Advance Credit In America", 2001, p. 30.

[8] "Payday Lending: Do Outrageous Prices Necessarily Mean Outrageous Profits?" by Aaron Huckstep, Fordham Journal of Corporate and Financial Law, Vol 12, 2007, p. 215, 218.

[9] "Payday Advance Credit In America", 2001, p. 32.

[10] "Payday Advance Credit In America", 2001, p. 35.

[11] Technically Prop. 200 reduces the maximum rate from $17.65 per $100 to $15 per $100. "High-Cost Payday Lending Traps Arizona Borrowers, Center for Responsible Lending," by Leslie Parish, September 16, 2008, Appendix 1, http://www.200isnoreform.com/wp-content/uploads/2008/09/crl-report-az-financial-quicksand-r9-161.pdf.

Most remarkably, in Florida 8 percent of Payday Loan customers take out 20 or more loans per year, and generate 20 percent of the business for Payday loan companies with the same reforms being promised for Arizona.

Most notably the customers show a wide range in usage with about 16 percent using Payday loans once or twice a year and 23 percent using Payday loans 14 or more times per year.[12]

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Payday loan customers were also three times more likely (18.5 percent to 5.3 percent) to have monthly consumer debt to income ratios of 30 percent or higher compared to the general population. That is debt payment on credit cards and payday loans that are at least 30 percent of their income.[14] Payday loan customers were also four times more likely to have filed for personal bankruptcy in the past five years.[15]

2. Even with proposed reforms 60 percent of Payday Loan business goes to borrowers who use 12 loans or more per year, who represent about one-fourth of customers.

One of the areas of confusion is between borrowers and loans. Those who wish to argue Payday loans benefit borrowers tend to emphasize borrowers, while those who argue that Payday loans place people in a debt emphasize the predatory trap of the Payday loan product.

The most pertinently data is from the state of Florida which has all of the reforms being proposed for Arizona. Since 20002, Florida has prohibited taking out more than one loan at a time, forbid rolling over a loan, required a 24 hour period between taking out a new loan after a loan repayment, has a statewide data base to track usage, and allows for any loan a 60 day repayment period. In Florida rates are capped at $10 per $100 borrowed plus a $5 verification fee

[12] "Payday Advance Credit In America", 2001, p. 39.

[13] "Payday Advance Credit In America", 2001, p. 44.

[14] "Payday Advance Credit In America", 2001, p. 45.

[15] "Payday Advance Credit In America", 2001, p. 46.

FIGURE 1

PAYDAY LOAN CUSTOMERS FROM FLORIDA AS REPORTED BY VERITEC

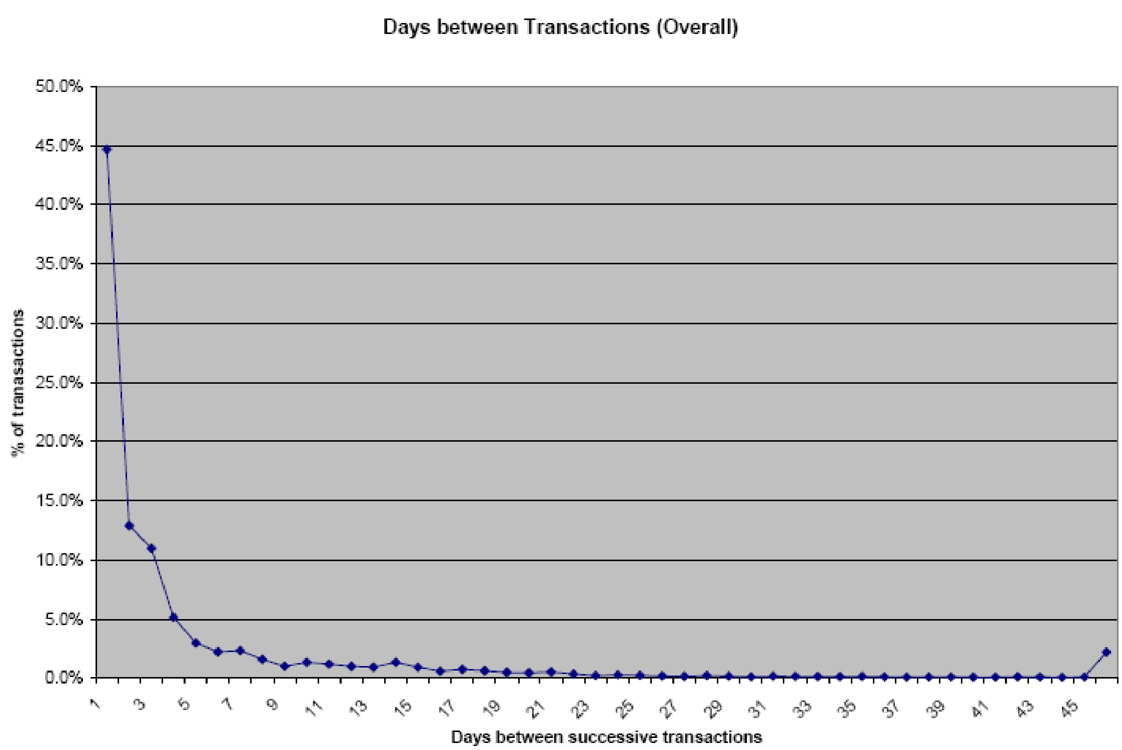
September 2006 through August 2007				
Number of Loans during period	% Total Loan Borrowers		% of Total Loans during period	
1	16.9%	73.0% of customers	2.1%	41.6 % of transactions
2	10.4%		2.6%	
3	8.0%		3.0%	
4	6.6%		3.3%	
5	5.7%		3.6%	
6	5.0%		3.8%	
7	4.6%		4.0%	
8	4.3%		4.3%	
9	4.0%		4.6%	
10	3.8%		4.8%	
11	3.8%		5.3%	
12	5.3%	27.0% of customers	8.0%	58.4% of transactions
13	2.8%		4.7%	
14	2.2%		4.0%	
15	2.0%		3.8%	
16	1.9%		3.8%	
17	1.7%		3.7%	
18	1.6%		3.6%	
19	1.5%		3.6%	
20	1.4%		3.5%	
21	1.3%		3.3%	
22	1.1%		3.2%	
23	1.1%		3.1%	
24	1.0%		3.0%	
25	0.9%		2.7%	
26	1.0%		3.3%	
27	0.2%		0.8%	
28	0.0%		0.1%	
29	0.0%		0.0%	
30 or greater	0.0%		0.0%	

Veritec, "White Paper Analysis of CRL Report: Springing the Debt Trap: Rate caps are Only Proven Payday Lending Reform," January 2008, p. 7.

on any loan.[16] Prop. 200 exactly mirrors these provisions except rates are capped 50 percent higher at $15 per $100 borrowed without the verification fee, but unlike Florida the extended repayment plan can only be used once per year at a particular lender.

In public policy it's not what's on paper but practice that counts. We can see that the reforms do an inadequate job of protecting chronic borrowers (see Figure 1 previous page reproduced from the company which is hired by the state of Florida to collect Payday loan information), as one-quarter of Payday loan customers generate 60 percent of the business for Payday loans, even with the protections that have been implemented in the state of Florida. Most remarkably, in Florida 8 percent of Payday Loan customers take out 20 or more loans per year, and generate 20 percent of the business for Payday

Figure 2



Veritec, "White Paper Analysis of CRL Report: Financial Quicksand," January 18, 2007, p. 12, for state of Florida.

[16] Veritec, "White Paper Analysis of CRL Report: Springing the Debt Trap: Rate caps are Only Proven Payday Lending Reform," January 2008, p. 12 and . Veritec, "White Paper Analysis of CRL Report: Financial Quicksand," January 18, 2007, p. 9.

loan companies with the same reforms being promised for Arizona. Is this change or more of the same?

Veritec also provides evidence that illustrates how despite a ban on rollovers—where one loan is taken out to pay another, the typical two-week loan repayment period places many borrowers in such a tight financial situation that they are forced to take out another loan within one week of the loan they just repaid.

Veritec's data from Florida shows that even with the rollover prohibition, 75 percent of consecutive loans come within five days of the repayment of the original loan, clearly illustrating the inadequacy of the two-week repayment process and showing that many customers end up paying multiple fees for what is essentially the same loan (see Figure 2 above). Most likely this is because borrowers think they can payback a loan in two-weeks, manage to do so, and then quickly fall short of cash again.

The average borrower in Florida takes out 8 loans during a calendar year for an average per loan amount of $380.[17] Since, in effect, under Prop. 200 they would be re-borrowing the same amount over the year with a $15 per $100 fee imposed each time, that borrower would be paying over the course of the year a total cost of $836 to access $380, a 120 percent annual rate as noted below.

Amount Borrowed	**$380**
Fees (8 times $57)	**$456**
Total Cost of Access to $380 credit during year	**$836**
Effective Annual Interest Rate	**120%**

The above figures are for an average borrower, but for more chronic borrowers the rate is much higher. A borrower taking out 12 loans

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[17] Veritec, "White Paper Analysis of CRL Report: Financial Quicksand," January 18, 2007, p. 8.; Veritec, "White Paper Analysis of CRL Report: Springing the Debt Trap: Rate caps are Only Proven Payday Lending Reform," January 2008, p. 13.

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3. Prop. 200 enhances Payday lender profits, while real reform would curtail profits

Prop. 200 if passed would enhance the profits of the Payday lending industry. Because the industry focuses on people who have credit difficulties or money management problems, they do appear to have higher loan default rates than commercial lending—at approximately 25 percent of outstanding loans compared to 5 percent for commercial banks. However, because fees are so high for Payday lenders, when expressed as a percent of revenues, loan losses have been estimated as between 15 to 20 percent for Payday lenders compared to 17 percent for mainstream banks. [18]

Data from Florida does indicate that between 20 and 25 percent of new loan requests are denied—or at least delayed (if they are seeking a new loan immediately after paying one back) and 97-98 percent of their loans are successfully repaid (keep in mind the average customer takes out 8 loans annually). [19] This suggests that Prop. 200 reforms would lower the default rate on loans to some degree and thereby enhance the industry's profit rate.

If the industry were to provide instead a loan product which required a minimum 90 day repayment option with a slightly higher per $100 fee of say $20, Payday lenders would lose revenue, because loan volume would decrease substantially and subsequently their fees—the basis of their business model. Yet such a product, especially if combined with financial management assistance, would give borrowers far better service in terms of building their own skills in financial management and demonstrating credit worthiness, so that they might be more successful in the future.

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[18] "Payday Lending: Do Outrageous Prices Necessarily Mean Outrageous Profits?" by Aaron Huckstep, Fordham Journal of Corporate and Financial Law, Vol 12, 2007, p. 229.

[19] Veritec, "White Paper Analysis of CRL Report: Springing the Debt Trap: Rate caps are Only Proven Payday Lending Reform," January 2008, p. 18; Veritec, "White Paper Analysis of CRL Report: Financial Quicksand," January 18, 2007, p. 5.